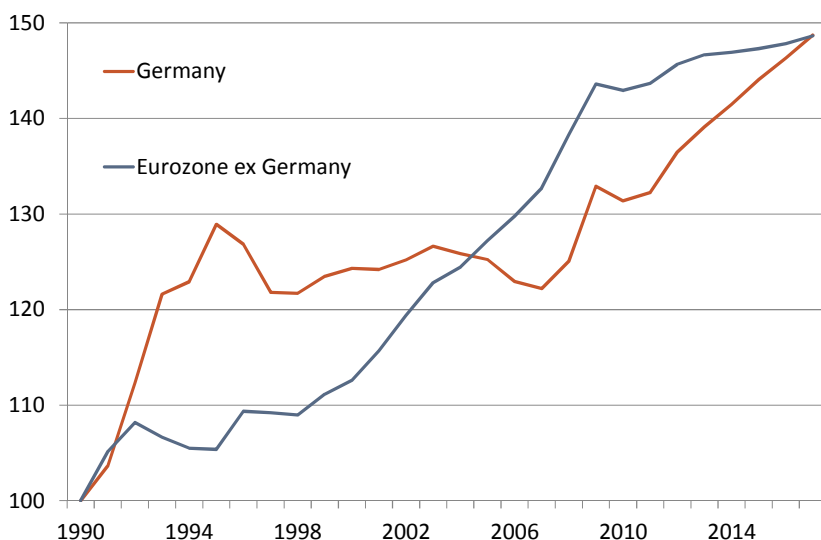


1 December 2017

## The great convergence: Eurozone labour costs

Nominal unit labour costs in Germany and the Eurozone ex-Germany, 1990=100



For lack of 1990 data, the Eurozone ex-Germany excludes Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia. Source: European Commission

- Sometimes, a simple chart can say it all:** The relative changes in nominal unit labour costs between Germany and the remainder of the Eurozone since 1990 can help to explain much of the recent economic history of the European continent. The trend in unit labour costs may even offer a glimpse into the future of the current economic upturn.
- Boom, bust and back:** In the wake of the German unification boom of 1990, labour costs surged across Europe. When other countries were forced to devalue against Germany, these countries gained a labour cost advantage, which allowed them to outgrow Germany from the mid-1990s onwards. Weighed down by the costs of unification and a lack of reforms (remember the “*Reformstau*”?) in the mid-1990s, Germany turned into the “sick man of Europe”.
- Adjustment within a currency zone:** Through wage restraint enforced by record unemployment and serious labour market reforms, Germany restored its competitive advantage from 1995 onwards while other countries became careless in the credit-driven heydays until 2007. The resulting imbalance came to haunt the Eurozone in the euro crisis. But with serious adjustment in major parts of the Eurozone and a rebound in German wages amid a rise in employment to record levels, that imbalance has now corrected itself again. In terms of their relative unit labour costs, Germany and the remainder of the Eurozone are now back to where they were in 1990. Of course, differences between the non-German members of the Eurozone persist, although they have also lessened.
- The correction of labour cost divergence is just one example of a general trend:** Structural reforms and adjustment efforts that helped to make the euro-periphery more flexible have now broadened to major laggards in core Europe, notably France, Belgium, Austria and Finland. This is the key result of [The 2017 Euro Plus Monitor](#), our annual flagship publication in which we assess the adjustment progress and the fundamental health of all 28 EU members. If the erstwhile crisis countries round off their adjustment efforts instead of reversing reforms, if the reform laggards shape up, and if fundamentally solid countries like Germany do not become overly complacent, the Eurozone may turn into a more balanced and more dynamic economy. These three big “ifs” illustrate the risks as much as the promise.
- German labour costs offer an insight into what may happen next:** While the rise in German unit labour costs (1.6% in 2016 and 2017 according to European Commission forecasts) outpaces that in the remainder of the Eurozone (0.6%), it is far less pronounced than in the early 1990s. It is not excessive. Globalisation and technological change, such as the rise of robots, continue to constrain wage settlements in Germany, whose economy is heavily exposed to international competition. Going forward, we expect wage inflation to edge up modestly. However, as business investment has started to rebound strongly after years of unusually subdued gains, faster rises in productivity could offset much of the acceleration in wage inflation. If so, that would leave unit labour costs on a path well compatible with the ECB’s inflation target. In Germany and – even more so – in the remainder of the Eurozone, economic growth can probably stay above trend for at least two more years without hitting serious inflationary bottlenecks.

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